

**THE ECONOMIC AND BUDGET OUTLOOK:
FISCAL YEARS 1996-2000**

The Congress of the United States
Congressional Budget Office

NOTES

Unless otherwise indicated, all years referred to in Chapter 1 are calendar years and all years in Chapter 2 are fiscal years.

Some figures in this report indicate periods of recession using shaded vertical bars. The bars extend from the peak to the trough of the recession.

Unemployment rates throughout the report are calculated on the basis of the civilian labor force.

Numbers in the text and tables of this report may not add to totals because of rounding.

National income and product account data shown in the tables do not incorporate the data for the fourth quarter of 1994, which were released on January 27, 1995.

Preface

This volume is one of a series of reports on the state of the economy and the budget that the Congressional Budget Office (CBO) issues each year. It satisfies the requirement of section 202(f) of the Congressional Budget Act of 1974 for CBO to submit periodic reports to the Committees on the Budget with respect to fiscal policy and to provide five-year baseline projections of the federal budget. In accordance with CBO's mandate to provide objective and impartial analysis, the report contains no recommendations.

The analysis of the economic outlook presented in Chapter 1 was prepared by the Macroeconomic Analysis Division under the direction of Robert Dennis and John F. Peterson. Christopher Williams wrote the chapter with contributions from Robert Arnold, Adrienne Kearney, and Frank Russek. Matthew Salomon carried out the economic forecast and projections. Robert Arnold, Laurie Brown, Douglas Elmendorf, Victoria Farrell, Douglas Hamilton, Adrienne Kearney, Kim Kowalewski, Joyce Manchester, Angelo Mascaro, Frank Russek, and Matthew Salomon provided background analysis and comments. Derek Briggs, Laurie Brown, John Romley, and Jennifer Wolfson provided research assistance.

The baseline outlay projections were prepared by the staff of the Budget Analysis Division under the supervision Paul N. Van de Water, Robert Sunshine, Paul Cullinan, Peter Fontaine, James Horney, Michael Miller, and Murray Ross. The revenue estimates were prepared by the staff of the Tax Analysis Division under the supervision of Rosemary D. Marcuss and Richard Kasten. Kathy A. Ruffing wrote Chapter 2, and James Horney wrote the summary of the report. The appendixes were written by James Horney (Appendix A), Kathy Ruffing (Appendix B), Bryan Grote (Appendix C), Jeffrey Holland (Appendix D), and Karin Carr (Appendix E).

An early version of the economic forecast underlying this report was discussed at a meeting of CBO's Panel of Economic Advisers. Members of this panel are Michael Boskin, Barry Bosworth, Robert Dederick, Martin Feldstein, Benjamin Friedman, Lyle E. Gramley, Robert Hall, Lawrence Klein, Robert Lawrence, John Makin, Burton Malkiel, Rudolph Penner, William Poole, Paul Samuelson, Charles Schultze, Robert Solow, James Tobin, and Murray Weidenbaum. Wynn V. Bussmann, Robert Crandall, William Gale, Edward Gramlich, Nicholas Lardy, Jonathan Skinner, and David Wyss attended as guests. Despite the considerable assistance afforded by these outside advisers, the analysis in this report does not necessarily reflect their views, nor are they responsible for any errors.

Paul L. Houts supervised the editing and production of the report, with the assistance of Sherry Snyder. Major portions were edited by Paul L. Houts, Leah Mazade, and Sherry Snyder. Christian Spoor provided editorial and production assistance. The authors owe thanks to Marion Curry, Dorothy Kornegay, and L. Rae Roy, who assisted in the preparation of the report. Kathryn Quattrone prepared the report for final publication.

Robert D. Reischauer
Director

January 1995

Contents

	SUMMARY	xi
ONE	THE ECONOMIC OUTLOOK	1
	The State of the Economy 3	
	CBO's Forecast for 1995 and 1996 5	
	Risks to the CBO Forecast 15	
	Comparison of the Forecast with the <i>Blue Chip</i> and the CBO Summer Forecasts 19	
	CBO's Projections for 1997 Through 2000 19	
TWO	THE BUDGET OUTLOOK	25
	The Deficit Outlook 25	
	Changes in the Budget Outlook Since August 31	
	The Spending Outlook 33	
	The Revenue Outlook 54	
	The Budget Outlook Through 2005 57	
	APPENDIXES	
A	Sequestration Preview Report for Fiscal Year 1996	63
B	An Analysis of Congressional Budget Estimates	69
C	How the Economy Affects the Budget	77
D	The Federal Sector of the National Income and Product Accounts	83
E	Historical Budget Data	89
F	Major Contributors to the Revenue and Spending Projections	103
	GLOSSARY	107

TABLES

S-1.	Comparison of Forecasts for 1995 and 1996	xiii
S-2.	The Economic Forecast and Projections	xiv
S-3.	CBO Deficit Projections	xvi
S-4.	Changes in CBO Deficit Projections	xviii
S-5.	Illustrative Deficit Reduction Path	xx
1-1.	The CBO Forecast for 1995 and 1996	2
1-2.	The Fiscal Policy Outlook	6
1-3.	Comparison of Forecasts for 1995 and 1996	20
1-4.	The Economic Forecast and Projections for Calendar Years 1995 Through 2000	21
1-5.	The Economic Forecast and Projections for Fiscal Years 1995 Through 2000	22
2-1.	CBO Deficit Projections	26
2-2.	CBO Projections of Trust Fund Surpluses	29
2-3.	Changes in CBO Deficit Projections Since August 1994	31
2-4.	How Tight Are the Discretionary Caps?	37
2-5.	Three Scenarios for Discretionary Spending and the Deficit	38
2-6.	CBO Projections of Outlays by Category, Assuming Discretionary Inflation After 1998	40
2-7.	CBO Baseline Projections for Mandatory Spending	41
2-8.	Sources of Growth in Mandatory Spending	43
2-9.	Outlays for Deposit Insurance in the CBO Baseline	47
2-10.	CBO Baseline Projections for Offsetting Receipts	49
2-11.	CBO Baseline Projections for Interest Costs and Federal Debt	51
2-12.	CBO Baseline Projections for Revenues, by Source	53

2-13.	Effect of Extending Tax Provisions That Have Recently Expired or Will Expire in 1995 Through 2000	56
2-14.	The Budget Outlook Through 2005 With Discretionary Inflation After 1998	58
2-15.	The Budget Outlook Through 2005 Without Discretionary Inflation After 1998	59
A-1.	CBO Estimates of Discretionary Spending Limits for Fiscal Years 1995 Through 1998	64
A-2.	Budgetary Effects of Direct Spending and Receipt Legislation Enacted Since the Budget Enforcement Act	67
B-1.	Comparison of the CBO March 1993 Baseline, the 1994 Budget Resolution, and Actual Outcomes for Fiscal Year 1994	70
B-2.	Sources of Differences Between Actual Budget Totals, CBO March 1993 Baseline Projections, and the Budget Resolution for Fiscal Year 1994	71
B-3.	Sources of Differences Between Actual Budget Totals and First Budget Resolution Estimates for Fiscal Years 1980 Through 1994	73
C-1.	Effects on CBO Budget Projections of Selected Changes in Economic Assumptions	78
C-2.	Effects on CBO Budget Projections of a Change in Inflation, Keeping Discretionary Spending Level After 1998	80
D-1.	Relationship of the Budget to the Federal Sector of the National Income and Product Accounts	84
D-2.	Projections of Baseline Receipts and Expenditures Measured by the National Income and Product Accounts	86
E-1.	Standardized-Employment Deficit and Related Series, Fiscal Years 1956-1994	91
E-2.	Revenues, Outlays, Deficits, and Debt Held by the Public, Fiscal Years 1962-1994 (In billions of dollars)	92
E-3.	Revenues, Outlays, Deficits, and Debt Held by the Public, Fiscal Years 1962-1994 (As a percentage of GDP)	93
E-4.	Revenues by Major Source, Fiscal Years 1962-1994 (In billions of dollars)	94

E-5.	Revenues by Major Source, Fiscal Years 1962-1994 (As a percentage of GDP)	95
E-6.	Outlays for Major Spending Categories, Fiscal Years 1962-1994 (In billions of dollars)	96
E-7.	Outlays for Major Spending Categories, Fiscal Years 1962-1994 (As a percentage of GDP)	97
E-8.	Discretionary Outlays, Fiscal Years 1962-1994 (In billions of dollars)	98
E-9.	Discretionary Outlays, Fiscal Years 1962-1994 (As a percentage of GDP)	99
E-10.	Outlays for Entitlements and Other Mandatory Spending, Fiscal Years 1962-1994 (In billions of dollars)	100
E-11.	Outlays for Entitlements and Other Mandatory Spending, Fiscal Years 1962-1994 (As a percentage of GDP)	101

FIGURES

S-1.	Comparison of CBO Projections With and Without Discretionary Inflation After 1998	xii
S-2.	Comparison of CBO Deficit Projections	xv
1-1.	The Economic Forecast and Projections	3
1-2.	The GDP Gap: GDP Versus Potential GDP	4
1-3.	Inflation and Tightening in the Labor Market	4
1-4.	Household Payments on Debt	7
1-5.	Consumer Spending on Motor Vehicles	9
1-6.	New Orders for Producers' Durable Equipment	9
1-7.	Relative Output and Net Exports	10
1-8.	The Exchange Rate	12
1-9.	Housing Affordability Index	12
1-10.	Change in Investment in Inventories	13
1-11.	Real Short-Term Interest Rates	14

1-12.	GDP and Potential GDP	23
2-1.	The Federal Deficit	27
2-2.	Outlays by Category as a Share of GDP	34
2-3.	Deposit Insurance Spending	46
2-4.	Revenues by Source as a Share of GDP	54
B-1.	Differences Between Actual Deficit and Deficit in First Budget Resolution	74
D-1.	A Comparison of NIPA and Unified Budget Deficits, Fiscal Years 1980-2000	87

BOXES

1-1.	Fiscal Policy and the Goal of a Balanced Budget	8
1-2.	The Currency Crisis in Mexico	11
2-1.	The CPI as a Measure of the Change in the Cost of Living	45
2-2.	The Debt Limit	52

Summary

No fundamental change in the economic or budget situation has occurred since the Congressional Budget Office (CBO) published *The Economic and Budget Outlook: An Update* in August 1994. The economy may be a bit more robust in 1995 than had been anticipated at that time, but a likely slowdown in growth in 1996 leaves the long-term economic outlook little different from last summer's. CBO expects that the high levels of business investment and purchases of durable goods that spurred the economy to a 3.7 percent real rate of growth in 1994 will continue into the first part of 1995. Because the economy is already operating close to its potential (the level of gross domestic product, or GDP, consistent with a stable rate of inflation), that growth is expected to result in somewhat higher rates of inflation and interest. In turn, those higher interest rates are likely to slow growth by the end of 1995--cutting it to 2.5 percent in 1995 and 1.9 percent in 1996 and dampening inflationary pressures. In CBO's longer-term projections, average annual growth after 1996 is close to the 2.4 percent rate of growth estimated for potential GDP; over the 1997-2000 period covered by those projections, inflation averages 3.4 percent and interest rates drift down.

CBO projects that the deficit will decline from the \$203 billion registered in 1994 to \$176 billion in 1995, the lowest level since 1989 and the lowest as a percentage of GDP (2.5 percent) since 1979. After reaching a trough in 1995, the deficit will rise to \$207 billion in 1996 (2.8 percent of GDP), grow again in 1997, and then level off in 1998. Those projections assume no change in current policies gov-

erning taxes and mandatory spending; they also assume compliance with the limits on discretionary appropriations that are in place through 1998. Under the assumption that spending for discretionary programs increases at the rate of inflation after 1998, deficits will grow to \$284 billion (3.1 percent of GDP) in 2000, the last year of CBO's regular projections. Under an alternative baseline that assumes that discretionary spending remains frozen at the dollar level of the 1998 caps, deficits increase only to \$243 billion in 2000.

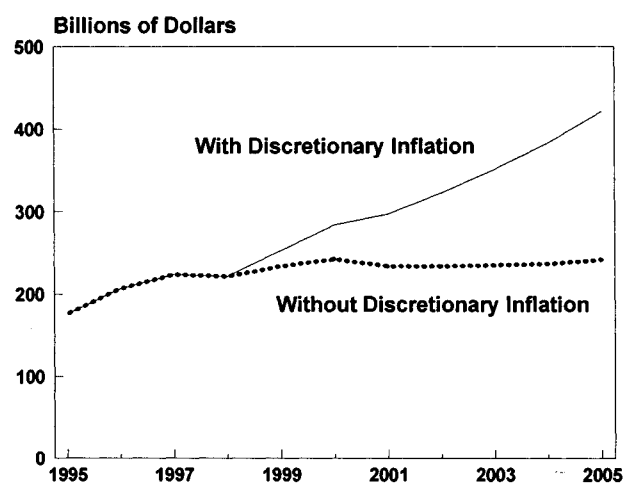
CBO's extended projections for 2001 through 2005, which are less detailed than those through 2000, show deficits continuing to mount in dollar terms through 2005 if discretionary spending is adjusted for inflation after 1998 (see Summary Figure 1). Deficits also grow as a percentage of GDP--to 3.6 percent in 2005. There is no reason to believe that this trend will be reversed in the years after that; indeed, the growth in the deficit is likely to accelerate in the second decade of the 21st century as large numbers of baby boomers become eligible for Social Security and Medicare benefits. Extended baseline projections that assume that discretionary spending is frozen at the 1998 level show deficits that are nearly constant from 2000 through 2005. As a percentage of GDP, the deficit in that baseline shrinks from 2.7 percent in 1998 to 2.1 percent in 2005.

Higher-than-anticipated interest payments and lower revenues, which are only partially offset by lower spending for medical care programs, have pushed up CBO's deficit projections for fiscal years 1995 through 1999 from last August's estimates by

an average of almost \$25 billion a year. After 2002, however, the deficits in the new extended projections are a little lower than the deficits projected in August.

The Congress is considering a constitutional amendment, which could go into effect as early as 2002, requiring a balanced budget. CBO currently projects a deficit of \$322 billion for that year (assuming that discretionary spending is adjusted for inflation after 1998), which is only \$3 billion more than the amount estimated last August. To illustrate the magnitude of the task facing those who would have to enact policies to comply with the balanced budget requirement, CBO has constructed an illustrative path leading to a balanced budget in 2002 that entails deficit reduction of \$1.2 trillion over the 1996-2002 period. Major changes in current policies would be required to achieve deficit reduction on that scale.

Summary Figure 1.
Comparison of CBO Projections With and Without Discretionary Inflation After 1998
(By fiscal year)



SOURCE: Congressional Budget Office.

NOTE: Caps on discretionary spending are set by law through 1998. Measures of the deficit "with discretionary inflation" assume that discretionary spending grows at the rate of inflation after 1998. Measures of the deficit "without discretionary inflation" assume that discretionary spending remains frozen in dollar terms at the level of the 1998 caps.

The Economic Outlook

CBO forecasts that the strong economic growth that the nation experienced throughout 1994 will continue into the first part of 1995. Because the economy is operating close to its potential, that growth will increase inflationary pressures and is likely to trigger additional efforts by the Federal Reserve Board to rein in the economy with higher short-term interest rates. In the CBO forecast, the resulting moderate slowdown at the end of 1995 and during 1996 will gradually bring GDP back in line with potential output without seriously disrupting the economy. Even with somewhat higher short-term growth and the slowdown in 1996, the current economic projections for 1997 through 1999 are little different from those CBO made last August.

The Forecast for 1995 and 1996

The robust growth that the U.S. economy experienced in 1994 is likely to continue through the first part of 1995 but will fade by the end of the year. The 3.7 percent increase in real output (on a fourth-quarter-to-fourth-quarter basis) and the creation of over 3 million new jobs in 1994 were achieved without an increase in inflation, but that performance is not likely to be repeated in 1995 (see Summary Table 1). Because the economy is already operating close to its potential, it cannot persistently expand faster than the growth of potential output--estimated at 2.4 percent a year by CBO--without triggering modestly higher inflation.

The Federal Reserve, which is determined to avoid any significant increase in inflation, raised the federal funds rate by 250 basis points (2.5 percentage points) in 1994 and is likely to further boost short-term interest rates in 1995. CBO forecasts that 90-day Treasury bill rates will average 6.2 percent in 1995--up from 3.2 percent in the first quarter of 1994. Rates for 10-year Treasury notes are expected to increase more modestly. The high rates of business investment and personal consumption of durable goods that drove the economy forward in 1994 apparently have not yet declined and will keep growth strong in the first part of 1995. However, by 1996,

Summary Table 1.
Comparison of Forecasts for 1995 and 1996

	Actual 1993	Estimated 1994	Forecast	
			1995	1996
Fourth Quarter to Fourth Quarter (Percentage change)				
Nominal GDP				
CBO	5.0	6.3	5.3	4.7
<i>Blue Chip</i>	5.0	6.5	5.7	5.4
Real GDP ^a				
CBO	3.1	3.7	2.5	1.9
<i>Blue Chip</i>	3.1	3.8	2.5	2.2
Implicit GDP Deflator				
CBO	1.8	2.5	2.8	2.8
<i>Blue Chip</i>	1.8	2.6	3.1	3.2
Consumer Price Index ^b				
CBO	2.7	2.8	3.2	3.4
<i>Blue Chip</i>	2.7	2.8	3.5	3.5
Calendar Year Averages (Percent)				
Civilian Unemployment Rate				
CBO	6.8	6.1	5.5	5.7
<i>Blue Chip</i>	6.8	6.1	5.6	5.7
Three-Month Treasury Bill Rate				
CBO	3.0	4.2	6.2	5.7
<i>Blue Chip</i>	3.0	4.2	6.2	6.1
Ten-Year Treasury Note Rate				
CBO	5.9	7.1	7.7	7.0
<i>Blue Chip</i> ^c	5.9	7.1	7.9	7.6

SOURCES: Congressional Budget Office; Eggert Economic Enterprises, Inc., *Blue Chip Economic Indicators* (January 10, 1995); Department of Commerce, Bureau of Economic Analysis.

NOTE: The *Blue Chip* forecasts are based on a survey of 50 private forecasters.

a. Based on constant 1987 dollars.

b. The consumer price index for all urban consumers (CPI-U).

c. *Blue Chip* does not project a 10-year note rate. The values shown here for the 10-year note rate are based on the *Blue Chip* projections of the Aaa bond rate, adjusted by CBO to reflect the estimated spread between Aaa bonds and 10-year Treasury notes.

the cumulative effect of past and future hikes in interest rates should begin to bring the economy back in line with potential output. As a result, CBO expects that growth of real GDP will slow to 1.9 percent in 1996.

Unemployment will remain low in 1995--it is forecast to average 5.5 percent, compared with 6.1 percent in 1994--but will climb to 5.7 percent in 1996. Even at 1996's slightly higher level, unemployment will be below CBO's estimate of 6.0 percent for the nonaccelerating inflation rate of unemployment (NAIRU). A sustained unemployment rate below the NAIRU indicates a future increase in wage

inflation. With unemployment below the NAIRU and GDP exceeding potential output, inflation is expected to rise in 1995 and 1996. Because the economy has not become too overheated and is expected to cool down later this year, the forecast upswing in the consumer price index for all urban consumers (CPI-U) is modest--from 2.8 percent in 1994 to 3.2 percent and 3.4 percent in 1995 and 1996, respectively (see Summary Table 1).

CBO's forecast assumes that the recent and anticipated future increases in short-term interest rates engineered by the Federal Reserve will restrain the economy to an appropriate degree. If the continuing

Summary Table 2.
The Economic Forecast and Projections (By calendar year)

	Estimated 1994	Forecast		Projected			
		1995	1996	1997	1998	1999	2000
Nominal GDP (Billions of dollars)	6,735	7,127	7,456	7,847	8,256	8,680	9,128
Real GDP (Billions of 1987 dollars)	5,338	5,505	5,602	5,736	5,870	6,004	6,141
Real GDP (Percentage change)	4.0	3.1	1.8	2.4	2.3	2.3	2.3
Implicit GDP Deflator (Percentage change)	2.1	2.6	2.8	2.8	2.8	2.8	2.8
CPI-U (Percentage change) ^a	2.6	3.1	3.4	3.4	3.4	3.4	3.4
Unemployment Rate (Percent)	6.1	5.5	5.7	5.8	5.9	6.0	6.0
Three-Month Treasury Bill Rate (Percent)	4.2	6.2	5.7	5.3	5.1	5.1	5.1
Ten-Year Treasury Note Rate (Percent)	7.1	7.7	7.0	6.7	6.7	6.7	6.7

SOURCE: Congressional Budget Office.

a. CPI-U is the consumer price index for all urban consumers.

strong growth that CBO foresees in early 1995 does not take place--if the economy has already started to cool off--the expected additional monetary tightening will slow growth sooner and more sharply than anticipated. Alternatively, if the economy proves stronger and more resistant than expected to the anticipated increases in interest rates and it surges well above potential output, the Federal Reserve will probably respond with even higher interest rates to combat the risk of inflation. That stronger-than-expected growth and the Federal Reserve's response to it could usher in a cycle of boom and bust for the economy.

Some economists argue that potential output may be greater than CBO estimates, in which case the economy could grow at its current rate for some time without triggering higher inflation. The Federal Reserve, however, is unlikely to allow such growth unless the evidence for a shift in potential output is more compelling than it currently is.

Projections for 1997 Through 2000

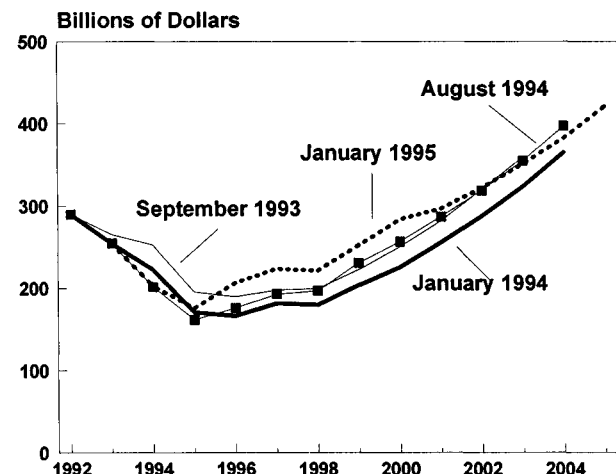
CBO attempts to forecast the cyclical fluctuations in the economy only for the next two years. Beyond 1996, its projections are based on trends in fundamental factors that determine the potential growth of the economy, including growth in the labor force, productivity, and national saving.

CBO's projections follow a path that has the gap between GDP and potential GDP reaching its historical average level--with GDP 0.6 percent below potential--at the end of the projection period in 2000. Because CBO estimates that the level of GDP will exceed potential output in 1996, the average annual real growth projected for 1997 through 2000 is slightly below the estimated 2.4 percent rate of growth of potential output (see Summary Table 2). Unemployment is expected to increase slightly to 6.0 percent, the estimated level of the NAIRU. Projected consumer price increases are assumed to average 3.4 percent a year over the period, with projected interest rates declining from the levels associated with efforts to slow the economy in 1995 and 1996.

The Budget Outlook

Although CBO now projects that the deficits for fiscal years 1995 through 1999 will be almost \$25 billion a year higher, on average, than it anticipated last August, the fundamental budget outlook is not very different from the one CBO projected then. Moreover, there has been no substantial change in CBO's deficit projections since its report in September 1993, which for the first time reflected the more than \$400 billion in deficit reduction enacted in the Omnibus Budget Reconciliation Act of 1993 (see Summary Figure 2). The deficit is still expected to fall in 1995 to its lowest level since 1989 and its lowest point as a percentage of GDP since 1979. As was also the case in August, the deficit is projected to begin rising again in 1996. CBO's extended budget projections show that trend continuing through 2005 if spending for discretionary programs increases at the rate of inflation after 1998. After 2002, currently projected deficits are slightly lower than the deficits forecast in August.

Summary Figure 2.
Comparison of CBO Deficit Projections
(By fiscal year)



SOURCE: Congressional Budget Office.

NOTE: The projections assume that discretionary spending rises with inflation after the caps expire in 1998.

The Outlook for the Deficit

Since 1992's record-high shortfall of \$290 billion, the deficit has declined to \$255 billion (4.0 percent of GDP) in 1993 and \$203 billion (3.1 percent of GDP) in 1994. (Although a record in dollar terms, the 1992 deficit as a percentage of GDP was far short--at 4.9 percent--of even a postwar record.) CBO projects that the deficit will decline for a third straight year to \$176 billion (2.5 percent of GDP) in 1995 (see Summary Table 3). That gratifying trend is expected to end the next year, however, with the deficit climbing under current laws to \$207 billion (2.8 percent of

GDP) in 1996 and \$224 billion in 1997 (2.9 percent of GDP) before leveling off in 1998.

The standardized-employment deficit, which is an estimate of the deficit that would occur if the economy was operating at its potential, is of interest because it is a measure of the fiscal posture of the federal budget without the cyclical effects of the economy. When the economy is operating below potential, the deficit swells as a result of reductions in revenues and increased spending for programs such as unemployment insurance. When the economy is operating above potential, revenues are in-

Summary Table 3.
CBO Deficit Projections (By fiscal year)

	1994	1995	1996	1997	1998	1999	2000
In Billions of Dollars							
Baseline Total Deficit							
With discretionary inflation after 1998	203	176	207	224	222	253	284
Without discretionary inflation after 1998	203	176	207	224	222	234	243
Standardized-Employment Deficit ^a							
With discretionary inflation after 1998	187	200	216	223	221	247	273
Without discretionary inflation after 1998	187	200	216	223	221	228	233
As a Percentage of GDP							
Baseline Total Deficit							
With discretionary inflation after 1998	3.1	2.5	2.8	2.9	2.7	3.0	3.1
Without discretionary inflation after 1998	3.1	2.5	2.8	2.9	2.7	2.7	2.7
Standardized-Employment Deficit ^b							
With discretionary inflation after 1998	2.8	2.8	2.9	2.9	2.7	2.9	3.0
Without discretionary inflation after 1998	2.8	2.8	2.9	2.9	2.7	2.6	2.6

SOURCE: Congressional Budget Office.

NOTE: Caps on discretionary spending are set by law through 1998. Measures of the deficit "with discretionary inflation" assume that discretionary spending grows at the rate of inflation after 1998. Measures of the deficit "without discretionary inflation" assume that discretionary spending remains frozen in dollar terms at the level of the 1998 caps.

- a. Excludes the cyclical deficit and spending for deposit insurance.
- b. Shown as a percentage of potential gross domestic product.